United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

75-4162

To Be Argued By
WALLACE MUSOFF

IN THE

United States Court of Appeals

FOR THE SECOND CIRCUIT

Docket No. 75-4162

SEYMOUR SILVERMAN, ET AL.,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

BRIEF FOR PETITIONERS-APPELLANTS

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BRIEF FOR THE PETITIONERS-APPELLANTS

Opinion Below

The opinion of the Tax Court (A328-337) is a memorandum opinion by Judge William H. Quealy and is reported as T.C. Memo 1974-285. That opinion was not reviewed by the Court below, although a motion for such review was filed.

Jurisdiction

The gift tax returns of the Petitioners-Appellants for 1968 were filed with the District Director of Internal Revenue, Brooklyn, N.Y., and the Petitioners-Appellants' legal residences lie within the jurisdiction of the United States Court of Appeals for the Second Circuit. This case was heard on March 27 and March 29, 1974 and the decisions were entered on May 20, 1975 finding deficiencies in gift taxes as follows:

Seymour Silverman	$ 43,890
Helen Silverman	43,890
Jack Silverman	94,395
Frances Silverman	94,395

The jurisdiction of this Court rests upon Sections 7482 and 7483 of the Internal Revenue Code of 1954.

Questions Presented

I

Is the finding of the Court below that the fair market value was $25 a share for 51,360 shares of Class B Non-Voting Common Stock of Modern Maid Food Products Inc. transferred by gift on August 21, 1968 and 25,800 shares of such stock transferred by gift on September 24, 1968, clearly erroneous?

II

When the Commissioner of Internal Revenue acknowledges error in the issued statutory notice of deficiency with respect to values, upon whom does the burden of proof then fall?

III

Did the Tax Court err as a matter of law in the criteria used in determining value so as to deprive Petitioners-Appellants of due process of law?

Statutes and Regulations Involved

The statutes and regulations involved are set forth in the Appendix to the Brief, printed separately.

Statement of the Case

Modern Maid Food Products, Inc. ("Modern Maid") to provide an incentive to its essential employees and business related individuals to invest in the Corporation, thereby ensuring their continued relationship, and to provide a return to major shareholders, proposed to recapitalize and requested a ruling from the Commissioner of Internal Revenue with respect to such proposed recapitalization (Ex. 5-E; A 20).

Upon receipt of approval Modern Maid did recapitalize and entered into an agreement to sell 4,790 shares of Class B,

non-voting common stock on August 12, 1968 to 14 employees and three business related individuals. The selling price set was $10 a share (Stip. ¶12; A 18), the pro-forma unconsolidated book value at December 31, 1967.(1)

The number of shares of Class B common stock sold to the employees had no relationship to their compensation or position, but the selected employees bought what they could afford. (Stip. ¶12; A 18, 289).

The stock sold to the employees was not intended as compensation and Modern Maid did not claim any deduction for any possible value in excess of $10 a share on its tax return (A 126).

In August and September 1968, petitioners-appellants made gifts of Class B Common stock of Modern Maid to trusts for their respective children and valued said shares at $10 each.

The Commissioner of Internal Revenue issued a statutory notice of deficiency based upon a value of $48 a share. At the time of trial, the Commissioner conceded error and opted for $25 a share. In support thereof, he presented the appraisal report and testimony of Hugh MacMullan III, and the fact that after a

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(1) ($3,579,051 - $2,520,000) ÷ 108,000 shares.

second recapitalization in June 1969, eliminating the preferred stock and exchanging each share of Class B (non-voting) common stock for 6 1/2 shares of new voting common stock, the new common stock was the subject of a registration and public offering at $12 a share in October 1969 (fourteen months after the initial gift).

This public offering was not contemplated at the time of the gifts and arose out of subsequent happenings affecting the needs of Modern Maid (A 40, 42, 129, 131, 137, 141, 142, 331 fn.4).

Petitioners-Appellants objected to the introduction of the October 1969 registration statement and sale of stock to the public and to evidence of financial results not known at the time of the gifts as being irrelevant and immaterial to the determination of value in August and September 1968.

The Tax Court determined a value of $25 a share.

The facts disclosed by the record and found by the Tax Court are:

Modern Maid was organized on January 7, 1952 and has engaged in the business of manufacturing and selling breading and batter mixes for use by processors of shrimp, fish and poultry and the manufacturing and selling of prepared flour

mixes for mass feeding outlets such as hospitals, restaurants and hotels. The flour mixes are sold through wholesale grocers.

On April 22, 1968, the capitalization of Modern Maid, and the shares held by the respective shareholders, were as follows:

	Common Stock $100 Par Value	Preferred Stock $100 Par Value
Jack Silverman	1,284	265
Seymour Silverman	645	430
Harold Oppenheim	225	150
Stanley Silverman	3	10
Joel Silverman	3	10
Jack Silverman Foundation		575
Total	2,160	1,440

On April 22, 1968, Modern Maid Foods Products, Inc., requested a ruling from the Commissioner of Internal Revenue that a proposed reorganization qualify as a tax-free reorganization under the provisions of Section 368(a)(1)(E). Under the proposed reorganization, Modern Maid would increase authorized preferred stock $100 par value from 1,500 to 30,000 shares and create two new classes of stock, namely (a) 24,000 shares of voting Class A common stock par value $10 per share and (b) 96,000 shares of non-voting Class B common stock, par value $10 per share. Each share of the original common stock would thereupon be exchanged for 10 shares new Class A common, par value $10 per share, 40 shares new Class B common, par value

$10 per share, and 11 shares preferred par value $100 per share.

On June 28, 1968, the Commissioner of Internal Revenue issued his ruling with respect to Modern Maid's request of April 22, 1968.

On July 13, 1968, Modern Maid voted to adopt the proposed plan of reorganization, effective August 12, 1968. As a result of the reorganization, the outstanding capital stock of Modern Maid Food Products, Inc. was held as follows:

	Class A Common $10 par value	Class B Common $10 par value	5% Common Preferred Stock $100 par value
Jack Silverman	12,840	51,360	14,389
Seymour Silverman	6,450	25,800	7,525
Harold Oppenheim	2,250	9,000	2,625
Stanley Silverman	30	120	43
Joel Silverman	30	120	43
Jack Silverman Foundation			575
	21,600	86,400	25,200

On August 12, 1968, Modern Maid entered into an agreement for the sale of unissued Class B common Stock to selected employees and legal counsel. The said agreement concerned purchases for investment purposes only and prohibited

the subscribing stockholders from disposing of or encumbering their Class B stock without the consent of the corporation. In absence of such consent or on the retirement or death of the subscribing stockholder, the agreement provided:

> " * * * The party [the subscribing stockholder or his estate] * * * shall give to the Corporation written notice by certified mail of his intention, and such notice shall contain an offer to sell all his stock in accordance with the terms of this agreement, within thirty (30) days after the date of such notice, the stockholder giving such notice shall sell and the Corporation shall purchase all of such stockholder's stock. "

The purchase price of each share was to be based on the value shown on the last Federal Income Tax return or on the annual financial statement, if such information was not on the return. The parties themselves could set any other value by agreement. Pursuant to this agreement, Modern Maid, in September 1968, sold 4,790 shares of its Class B common stock to said employees and associates at $10 per share.

Gifts of Class B common stock were made by Jack Silverman, Seymour Silverman and Harold Opeenheim on the dates

and in the amounts set forth below:

Date:	Donor	Donee	No. of Shares
8/21/68	Jack Silverman	Trust for Benefit of Joel Silverman	25,680
		Trust for Benefit of Stanley Silverman	25,680
		Total:	51,360
9/24/68	Seymour Silverman	Trust for Benefit of Susan Silverman	8,600
		Trust for Benefit of Anne Silverman	8,600
		Trust for Benefit of Beth Silverman	8,600
		Total:	25,800
12/8/68	Harold Oppenheim	Martin Oppenheim	2,000
		Sandra Oppenheim	2,000
		Trust for Benefit of Elysia Beth Oppenheim	2,000
		Trust for Benefit of Robert Alan Oppenheim	2,000
		Total:	8,000

On December 31, 1968, the following positions were held by the persons listed below:

Name	
Jack Silverman	President and Director
Harold Oppenheim	Vice President and Director

Name	
Seymour Silverman	Secretary-Treasurer and Director
Stanley Silverman	Director

Beginning in March 1969, negotiations were initiated on behalf of Modern Maid with Ladenburg, Thalmann & Co., investment bankers, with a view towards the sale of stock of Modern Maid in a public offering.

A special meeting of the stockholders was called on June 16, 1969, to amend the Certificate of Incorporation of Modern Maid, and to take such other actions as were necessary in order to meet the conditions prescribed in the agreement with Ladenburg, Thalmann & Co. for a public offering of the common stock of Modern Maid.

On June 16, 1969 pursuant to a plan of recapitalization the following exchanges occurred:

Preferred Share received	8.75 shs. Common
Class A Common received	7 shs. Common
Class B Common received	6.5 shs. Common

On October 28, 1969, Ladenberg, Thalmann & Co. issued its prospectus whereby it underwrote to publicly sell 350,000 shares new Common Stock at $12 per share. It acquired 100,000 shares from Modern Maid and 250,000 shares from selling stockholders.

The pro forma consolidated book value of Modern Maid at December 31, 1967 was $12.33 per share.[2]

The Consolidated Statement of Operations of Modern Maid and subsidiaries for the period December 31, 1964 to 1968, inclusive, and the 6-month period ended June 30, 1968 and June 30, 1969, was as follows:[3]

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(2) (3,851, 320-2,520,000) ÷ 108,000 sh.

(3) The financial data for the taxable years ended December 31, 1964 and 1965, and for the 6-month period ended June 30, 1968, are unaudited.

	Year, December 31,					Six Months Ended June 30,	
	1964	1965	1966	1967	1968	1968	1969
Net Sales	$8,255,805	$9,771,555	$10,673,769	$11,739,411	$13,478,372	$6,290,394	$7,046,273
Cost of sales (Note B)	5,291,198	6,291,795	7,162,996	7,709,696	8,743,482	4,076,175	4,493,504
Gross Profit	2,964,607	3,479,760	3,510,773	4,029,715	4,734,890	2,214,219	2,552,769
Selling, general and administrative expenses (Notes A and B)	2,105,095	2,300,100	2,413,066	2,788,565	3,088,817	1,451,081	1,620,274
Income from operations	859,512	1,179,660	1,097,707	1,241,150	1,646,073	763,138	932,495
Other Income (deductions):							
Interest Income	11,977	23,382	39,247	44,854	56,928	33,610	30,536
Other, net	(15,378)	(7,958)	(9,583)	(1,610)	(124)	--	(1,971)
	(3,401)	15,424	29,664	43,244	56,804	33,610	28,565
Income before provision for income taxes	856,111	1,195,084	1,127,371	1,284,394	1,702,877	796,748	961,060
Provision for Income Taxes:							
Federal	393,483	522,567	479,362	558,575	817,750	374,713	477,558
State and City	36,881	50,035	58,786	90,158	96,878	41,949	52,807
	430,364	572,602	538,148	648,733	914,628	416,662	530,365
Net Income	$ 425,747	$ 622,482	$ 589,223	$ 635,661	$ 788,249	$ 380,086	$ 430,695

Modern Maid's three major competitors with regard to its breading and batter mix products were Newlywed Baking Co. of Chicago, DCA Food Industries (formerly Donut Corporation of America), and Griffith Laboratories of Toronto, Canada. Its chief competitors in the prepared flour mix field were Pillsbury Flour Mills, General Mills, and DCA Food Industries.

There were no public sales of the common stock of Modern Maid prior to the underwriting by Ladenburg, Thalmann & Co., referred to above.(4) No evidence was presented to show any public or other sales of stock in any company which might be considered comparable to Modern Maid.

The Tax Court concluded that:

> "A multiple of ten times average earnings was a reasonable basis for the valuation of the Class A common stock of Moadern Maid.
>
> As of August 21, 1968, and as of September 24, 1968, the fair market value of the Class A common stock of Modern Maid was not less than $40 per share. As of the same date, the fair market value of the Class B common stock was not less than $25 per share."

Additional pertinent facts disclosed by the record and for which findings were requested on brief and then in a separate motion, but denied by the Tax Court (Judge Quealy) are set out in Nos. 2, 8, 9, 12, 13, 14, 18, 20-23, 25-34, 35, 36, 37, 38-56, 60-80 of the requested findings of act in the brief

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(4) The Court apparently has not considered sales of Class B common stock by Modern Maid to 17 individuals to be "public sales".

to the Tax Court (A 292-310, 338, 339).

Additional findings of fact supported by the record and requested in the Motion filed and denied on November 26, 1974 (A 338, 339) are:

> "The average return of net income on net worth at the beginning of the year for the Comparable Companies used by respondent's expert was 17.62% (see Computations on pp. 28, 29 of the petitioners' brief, based on data in Ex. Q, pp. 27, 41, 42). (5)
>
> "The Common Stock equity of Modern Maid Food Products, Inc. at December 31, 1967 represented approximately 26% of the total assets. (Ex. 8-H) The alleged comparable companies used by respondent's expert had an average common stock equity of 65% of total assets. (Computation on p. 32 of petitioners' brief based on data in Exhibit Q, pp. 38, 40, 41, 43)" (6)
>
> "All the acquisitions cited in the government expert's appraisal report in the schedule on page 50, which was the basis for computing his discount of 25% for a minority interest were for stock of the acquiring companies. (Prentice Hall Capital Adjustment Service through 1969, pp. C-49, L-18, L-82, M-85, M-204, R-93, U-45)."

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(5) Computation IBID p. 20

(6) Computation IBID p. 24

ARGUMENT

I.

THE FAIR MARKET VALUE OF 51,360 SHARES OF MODERN MAID FOOD PRODUCTS, INC., CLASS B COMMON STOCK TRANSFERRED BY GIFT ON AUGUST 21, 1968 AND 25,800 SHARES TRANSFERRED BY GIFT ON SEPTEMBER 24, 1968 WAS NOT IN EXCESS OF $5 A SHARE AND THE TAX COURT'S FINDING OF A VALUE OF $25 A SHARE IS CLEARLY ERRONEOUS.

The Tax Court's finding of $25 a share for the Class B common stock of Modern Maid in effect assumes a knowledgeable willing buyer to invest almost $2,000,000 (72,160 x $25) for non-voting common stock in a closely held corporation with no marketability, no voice in management, no return on investment,(7) no employment agreement, no right to even attend annual meetings or to receive financial reports.

Petitioners-Appellants contend that the very requirement of such a huge investment inherently limits the market for purchasers, and that a person with such funds has proven astuteness which would negate any possibility of investing such an amount in Modern Maid Class B common stock. Since corporate sales of Class B stock were being made in relatively small amounts (mostly in 100 to 400 share lots) to 17 buyers, the assumed buyers of

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(7) Class B common stock or subsequent new common stock has never paid a dividend.

the 72,160 shares transferred by gift would have to be limited to avoid violation of Securities & Exchange Commission's rules and regulations.

Although the Commissioner used a value of $48 a share in his statutory notice of deficiency, at the time of trial he opted for $25 a share, and presented only the testimony and appraisal report of Hugh A. MacMullan III (MacMullan) to support such value and the fact that after a second recapitalization in June 1969, eliminating the preferred stock and exchanging each share of Class B (non-voting) common stock for 6 1/2 shares of new voting common stock, the new common stock was the subject of a registration and public offering at $12 a share in October 1969 (fourteen months after the initial gift).

It is apparent from MacMullan's "Appraisal Qualifications" (Ex. Q; A. 104) that the thrust of his experience has been in real estate in both formal education and actual experience. MacMullan could only name one closely held company outside the real estate field whose stock he had appraised (A 194a). MacMullan had never been consulted with respect to the purchase of closely held stock (A 194a), but only in connection with a sale -- a posture which would condition an appraisal toward the high side, the asking price. MacMullan had no experience

in counselling purchases of securities of closely held companies (A 194a).

MacMullan's appraisal value of $25 a share for the Class B common stock of Modern Maid was based on the market price, operations and net worth of five companies, alleged initially to be comparable. These companies were Martha White Foods, Inc. ("Martha White"), B. Manischewitz Co.("Manischewitz"), Bridgeford Foods Corp. ("Bridgeford"), Saps Foods Inc. ("Saps Foods") and Spaulding Bakeries, Inc. ("Spaulding") (Ex. Q; A 108-114).

The activities of these companies are fully set out in Petitioners' Requested Findings of Fact, Nos. 51-55 (A 305, 306) and need not be repeated here. None of these companies was in any way comparable to or a competitor of Modern Maid (Stip. ¶3, A. 15 cf. Ex Q, A 108-114).

MacMullan's so-called "comparables" were engaged in milling, processing flour, and distributing corn meal, dried beans and mixed feed; selling matzos, beet soup, baby goods, "gefilte" fish, pickles, candies, sacramental wine; fresh,frozen processed and smoked meats and bakery products; and operating bakeries. How can these activities possibly be comparable with those of Modern Maid which was manufacturing and selling breading and batter mixes to the frozen food industry and prepared ready-to-use flour mixes to large commercial consumers?

MacMullan upon cross examination admitted his "comparable companies" were not really comparable with Modern Maid. (A 198, 202)

MacMullan selected his "comparables" because to some degree they used the same raw material - wheat flour. (A 210, 212). Using such a standard for comparability, common raw material, a bridge building company would be comparable with a tractor manufacturer, an automobile company, or a lawn mower manufacturer since steel is a common raw material; a plastic hanger manufacturer would be comparable with a manufacturer of formica since they buy the same raw material, pelletized plastic resins; a chicken raiser would be comparable with a manufacturer of cornmeal since they may use the same raw material, corn.

With respect to the activity where the same raw material, wheat flour, was used, MacMullan didn't know what were the sales and net income from that phase of activity. (A 212, 213). Thus, Bridgeford might have 90% of its business from processed meats and only 10% from frozen bread dough with net income from such activities bearing no relationship to sales and even losses being sustained in the phase using wheat flour as a raw material. The same condition prevails with respect to Martha White, Manischewitz and Saps Foods.

Moreover, the market to which MacMullan's "comparables" sold was not the same as that sold by Modern Maid. Spaulding was selling a trade name product to retail outlets for public consumption. Saps Foods was selling to supermarkets and vending machine operators, again for retail consumption. Manischewitz was also selling to retail outlets for public consumption. Modern Maid, however, was selling to industrial processors and large commercial users.

Petitioners submit the very foundation of MacMullan's appraisal is so porous and lacking in substance that it could not and should not pass the careful inspection of any Court.

Analysis of the specific methods used by MacMullan also shows a strained effort to reach a specific result. In his "Return on Net Worth Approach", MacMullan has based his percentage of return on the net worth at the end of the year, which is obviously in error. Such net worth is affected by theearnings for and dividends paid in the year and was not available for business operations at the beginning or during the year. If this method is to be used, the return on net worth should be based on the net worth at the beginning of the year or the average net worth for the year. In addition, MacMullan erred in using Bridgeford's net worth at October 31, 1969, including the proceeds of 100,000 shares at 8-3/4 offered

in December 1968 and earnings for the year ended October 31, 1968 (Ex. Q., A 110), and the net worth of Saps Foods at May 31, 1969 and earnings for year-end May 31, 1968. (Ex. Q, A 113).

Using beginning of year net worth and correcting for Bridgeford and Saps Foods net worth, the percent of net income to net worth would be:

	Beginning Of Year	
Martha White Foods, Inc.	17.96%	
B. Manischewitz Co.	7.45%	
Bridgeford Foods Corp.	24.32%	(8)
Saps Foods, Inc.	24.56%	(9)
Spalding Bakeries, Inc.	13.79%	
Average %	17.62	

So we not only have the use of companies that are not even related (perhaps as 6th cousins), but there are errors in application that virtually destroy MacMullan's appraisal values. For with an average return of 17.62% on net worth for other companies, there are only nominal excess earnings of Modern Maid to be capitalized as goodwill, even using MacMullan's estimate of net worth of Modern Maid at June 30, 1968 of $4,200,000. (Ex. Q; A 93).(10)

(8) $263,838/$1,085,006
(9) $181,227/$ 737,901
(10) $4,200,000 net worth x 17.62% average return of "comparable companies" gives $740,000 of earnings and the following valuations:

MacMullan's Price Earnings Ratio Approach has the same inherent defects: so-called comparables are not related, and he has used an arithmetic mean of the high and low for the calendar year 1968 in computing Price/Earnings ratio although the earnings of the same companies are for years ended May 31, 1968, June 1, 1968, July 31, 1968, November 1, 1968 and only one for the year ending December 31, 1968.

(10) cont'd.

	1/1/68		6/30/68
Net Worth per Books	$ 3,850,000		$ 4,200,000
Comparable Percent of Return	17.62%		17.62%
Relative Net Income	$ 678,000		$ 740,000
6 Months Earnings Annualized	760,000		760,000
Excess Earnings	$ 82,000		$ 20,000
Capitalized at Average Rate of Return	17.62%		17.62%
Goodwill	$ 465,000		$ 110,000
Net Worth Per Books (consolidated)	3,850,000		4,200,000
Value of Company	$ 4,315,000		$ 4,310,000
Preferred Stock	2,520,000		2,520,000
Balance - Common Stock	$ 1,795,000		$ 1,790,000
Value per Share ÷ 108,000	16.62		16.57
		$16.60	

	Per MacMullan		Per Court Cases
Computed Value from Public Comparables	$ 16.60		$ 16.60
Discount for Minority Interest and no Market - (25%)	4.15	35%	$ 5.80
	12.45		10.80
Discount for Class B Limitations - (16 2/3%)	2.08	8%	.86
	10.37		9.94

No consideration has been given to the number of shares sold at a particular price. Thus, if during the year, 20,000 shares in the aggregate sold at prices ranging from $6 -$10, and a few 100 share lots sold up to $20, Mr. MacMullan would be using a market price of $13 [(20 ÷ 6) ÷ 2] in computing his Price/Earnings ratio. Mr. MacMullan, himself, recognized this factor when he stated the use of an average price in the event of large fluctuations could give distorted results. (Ex. Q., A 100,101).

Furthermore, with respect to Bridgeford, he used the price of a public offering in December 1968 instead of his own adopted arithmetic average. As a result, he has a Price/Earnings ratio for that company of almost 20. Martha White's Price/Earnings ratio was affected by a stock split in 1968, with an attendant rise in stock value (Ex. Q, A 108). Moreover, Martha White, Bridgeford and Spaulding were all paying cash common stock dividends.

The Comparable Public Enterprise Approach of MacMullan must also fall since it is bottomed on results of companies that bear no relation to that of Modern Maid.(11) It also used average market prices for 1968 which Mr. MacMullan has admitted could give distorted results (Ex. Q, A 100,101) and, furthermore, relates such 1968 averages to earnings for different fiscal years ending prior to December 31, 1968. Thus, for Martha White,

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(11) IBID. pp. 17 - 21

Mr. MacMullan has for year ended June 1, 1968 income of 4.68% of total average market value for the calendar year 1968. This is based upon an average market price of $28. We are not given the average market price for year ended June 1, 1968. Obviously, stock prices from June 1, 1968 to December 31, 1968 are related to earnings for that period and a projection beyond, which earnings have not been considered by MacMullan in his Appraisal Report.

The unreliability of Mr. MacMuallan's data for his "Comparable Public Enterprise Approach" is brought into focus by the extreme variation in company statistics. On page 33 of Exhibit Q (A 98, 99) one sees net worth as a percentage of total market value ranging from 26.73% to 126.40%, almost a 5 to 1 variation. Sales as a percentage of total market value fluctuate from 129.29% to 335.25%, better than a 2-1/2 to 1 ratio. As stated earlier,(12) MacMullan's net worth figures are erroneous with respect to Bridgeford and Sap's Foods.

The market value of shares of stock not only reflect earnings, net worth and sales, but also dividends,growth, nature of industry, name goodwill and sponsorship. Martha White and Manischewitz, Bridgeford and Spaulding were all dividend paying issues, and other factors being equal would have a higher price/earnings, price/net worth and price/sales ratios. Modern Maid has

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(12) IBID pp. 19, 20

not paid a single dividend on its common stock after November 1967. Any amounts paid prior to that time were nominal, being only a small fraction of the preferred dividend requirements after the recapitalization of August 12, 1968.

Martha White, Manischewitz and Spaulding had trade named products sold at retail with Martha White and Manischewitz having national distributions of some of their products, making their names known to millions of people. Modern Maid was an unknown name except to its few suppliers and industry customers.

The pro-forma common stock equity of Modern Maid in August 1968, upon reorganization, represented only 25.96% of total net worth plus liabilities (A 323).[13] In contrast, MacMullan's comparables show a much more substantial capital posture as set out below:

	Common Stock Equity in 000s	Net Worth plus Liabilities in 000s	Percent Of Common Stock Equity
Martha White y/e 6/1/68	$ 8,281	$ 11,433	72.43
Manischewitz y/e 7/31/68	3,690	5,507	67.01 (14)
Bridgeford y/e 11/1/68	1,299	2,239	58.02
Spaulding y/e 12/28/68	2,798	4,501	62.16
Average:			64.90

Sap Foods was not included since the evidence before the Tax Court does not contain any balance sheet data prior to May 31, 1969.

The risk inherent in a speculative common stock investment where the common stock equity is preceded by debts and prior

(13) ($3,851,320 - $2,520,000) ÷ $5,128,345)
(14) This became 63.81% in December, 1968 and the average became 66.35%

equity of almost three times the common stock as in the case of Modern Maid Inc. would necessarily be reflected in the market price. MacMullan has given no consideration to this condition although his "comparables" reflect a ratio of common stock equity to total capital and liabilities as high as 72.43% for Martha White Foods and an average of 64.90%.

To recapitulate, we have in the "Comparable Public Enterprise Approach" (Ex. Q; A 97) the use of companies unrelated in product and market, sharply differing in capital structure, four of the five alleged comparables were paying dividends on their common stock, (whereas, Modern Maid was not), and the use of average market prices for a substantial period of time beyond the earnings, net worth and sales periods reflected in the financial statements.

In his "Price-Earnings Ratio Approach" and "Comparable Public Enterprise Approach", MacMullan uses an 8% cost for floating a public issue of Modern Maid (Ex. Q, A. 96). Mr. Herbert Cannon ("Cannon") who has participated in some three hundred million dollars of public offerings in 1962 through 1970, after delineating the various costs of "going public", arrived at a figure of 15% as the cost of going public for a company of the size of Modern Maid. This percentage cost of 15% was also the opinion of Mr. Gordon Smith ("Smith") of the American Appraisal Co.

(Ex. 18, A 63). In fact, in the tax case of Inga Bardahl, T.C.M. 1965-158 cited by MacMullan in his appraisal report (Ex. Q, A 117) as one of the court cases guiding him, the government expert determined a 20% cost for floating a stock issue to the public, which percentage was accepted by the Court in that case.

McMullan's figures were based on Securities & Exchange Commission data admittedly for years long before 1968, and did not take into consideration any costs other than underwriting commissions. He admitted there were also costs for legal and accounting fees. He did not know of a signle instance other than for Modern Maid where a public issue in 1968 or 1969 had an underwriting cost of only 8%. (A 216).

MacMullan, himself, recognized discounts for minority interests may be as much as 50%, but applied a 25% discount based upon a schedule set out on page 50 of his appraisal report (Ex.Q; A 101).

This schedule of MacMullan's is erroneous in substance as well as computation. In this regard, it should be noted that the size of the transactions, the industries involved and the time period are completely foreign to the particulars of the case before the Court. MacMullan's schedule deals with such industry giants as Penzoil Co. and United Gas Corp. ("United"), Philadelphia & Reading Corp. ("Philadelphia") and Lone Star Steel Co.("Lone Star"), General Aniline & Film Corp. ("Aniline") and Rubberoid Co.

Costs of acquistion ranged from $7,400,000 to more than $800,000,000. Moreover, in three instances, the minority interest acquired gave the acquiring company 100% ownership, which fact could very well have impelled the payment of a higher price for the minority interest. E.g., discounts of 17%, 22% and 25% occurred when the minority interest was the second one acquired; whereas, discounts of 50% and 52% occurred in the same type of transactions, regardless of size, where the minority interest was the first acquired as in the LTV Electrosystems ("LTV") and Penzoil transactions.

A special comment is in order with respect to the acquisition of Rubberoid by Aniline. The acquisition of minority and majority interests took place the same month. Considering the time requirement for action by approving shareholders and the S.E.C., it had to be a unified transaction which MacMullan has split into two parts. Prentice-Hall Capital Adjustments Service for 1969 (page R-93) shows that Rubberoid was merged into Aniline on May 26, 1967, the stockholders of Rubberoid receiving 1 share of $1.20 conv. pfd. stock of Aniline for each share of Rubberoid. Obviously, payment in stock in a merger transaction is no criterion for the correct discount of a minority interest solely for investment.

All of the other acquisitions cited by MacMullan

involved payment in stock: 1) Penzoil's acquisition by merger of United Gas, whose shareholders on April 1, 1968 received 1/2 share of Penzoil United Corp., 4% conv. pfd. for each share of United,[15] 2) LTV's acquisition by merger of Memcor, Inc. on April 19, 1967 by issuing 7/16 share of common of LTV for each common share and one share LTV 6% pfd. for each 6% pfd. share of Memcor Inc.,[16] 3) U.S. Smelting & Refining's (Smelting) acquisition by merger of Mueller Brass on September 24, 1965 by exchanging for each share of Mueller Brass 42/100 share of Smelting $5.50 pfd. stock,[17] 4) Glen Alden Corp.'s acquisition by merger of Philip Carey Manufacturing Co. (Philip Carey) on June 1, 1967 by exchanging 1 share of Glen Alden $2.25 conv.pfd. for each share of Philip Carey,[18] 5) Diebold Inc.'s acquisition by merger of Lamson Corp. on July 9, 1965 by an exchange of 1 share of Diebold Inc. for each share of Lamson Corp.,[19] 6) Philadelphia's acquisition of all of the assets of Lone Star on April 1, 1966 for 5% pfd. stock which gave each shareholder in Lone Star 1/4 share of 5% pfd. stock of Philadelphia[20], 7) APL Corp.'s acquisition by merger

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(15) 1969 Prentice-Hall Cap. Adj. Service, Page U-45
(16) 1969 " " " " " , " M-85
(17) 1969 " " " " " , " M-204
(18) 1969 " " " " " , " C-49
(19) 1969 " " " " " , " L-18
(20) 1969 " " " " " , " L-82

of U.S. Consumer Products on May 20, 1966 by issuing 1 share of APL Conv. pfd., Series B for each share of U.S. Consumer Products.(21)

Surely, MacMullan who testified as respondent's expert stock appraiser could have verified with respect to his important aspect the nature of the transactions being cited by him, as peititioners' counsel did, particularly when MacMullan did not know whether the acquisition prices used by him were in cash or stock (A 255). It is apparent once more that MacMullan's appraisal was just statistically constructed without regard to rationality. Suppose the average rainfall in the United States is 30 inches and in Canada is 25 inches. Should one say, therefore, Death Valley, California has 20% more rainfall than Toronto, Canada? Or, should one argue that college coeducation is corruptive of studies because one-third of the female student body in a particular college married faculty, when upon analysis it is determined that only three female students were registered?

Statistical applications to be valid must meet the test of being rational and practical.

Obviously, where stock of a public company is acquired for stock in another public company, at times with a time difference of more than two years, factors are introduced that make it impossible to measure the discount applicable to a minority interest. These factors are the difference in market price

(21) 1969 Prentice-Hall Cap.Adj. Service,Page U-59

of the stock being offered, the difference in market price of the stock being acquired, the business motivation for the initial purchase (possibly to obtain a "foot-in-the-door" for eventual takeover), and the business motivation for the second purchase. In all of MacMullan's illustrations, the second purchase resulted in 100% ownership which would give the acquiring corporation access to the cash and current asset position of the acquired company.

To illustrate briefly: Company A offers to acquire Company B by an exchange of stock, 2 shares of A for one share of B when A and B are selling at $20 and $30 a share respectively. B's stockholders consider this a generous offer and 82% of B's shareholders accept. The majority interest is then acquired at an effective $40 a share (2 shares of A). Two years later when shares of both companies are selling at $50 a share, A merges B into A by a share for share exchange. Actually, those making up the minority interest received only 1/2 as much as those making up the majority interest per share of stock, but the dollar value on a schedule of the type on page 50 of Ex. Q would be reflected as $50 a share for a minority interest and $40 a share for a majority interest. In such a case, a minority interest would be commanding a premium; whereas, it only received half as much as a majority. That condition

is buried in MacMullan's schedule for there were acquisitions of stock with a public market value for stock also with a public market value at different periods of time. Moreover, there were no true acquisitions of majority interest as such. Acquisition by tender offer is really the acquisition of many hundreds, sometime thousands of minority interests which in the aggregate become a majority interest. MacMullan's schedule on page 50 is no measure at all for a minority interest discount in a closely held corporation. Note the bidding in July-August 1974 by International Nickel & United Aircraft for the stock of ESB (Electric Storage Battery) Corp. Certainly the eventual price of $41 a share (up from $17 within a week), made on all or any basis, is not indicative of minority discount or majority premiums. It is only indicative of competitive bidding between two giant corporations for reasons of their own.

What MacMullan's schedule of discount determination fails to consider is that the companies in his schedule are public companies and the difference in price per 1% acquisition are for publicly traded companies; whereas, the minority interest in Modern Maid is a locked-in, non-liquid position in a closely held company.

Summarizing MacMullan's three valuation approaches, one finds:

The net worth approach has only nominal excess earnings to capitalize and correcting for structural errors gives a value of $10 a share.(22)

If the Price/Earnings Ratio approach of MacMullan is assumed and a realistic figure no greater than 10 (if public) is used, which both the Court below and Smith of the American Appraisal Company considered applicable (Ex. 18, A 61), the total value of Modern Maid would be $6,160,000 (10 times average earnings for the next three preceding years of $616,000), and the computation would be as follows:

Value of Company (Average Earnings x 10)		$6,160,000
Cost of Going Public - 15%		924,000
		$5,236,000
Preferred Stock		2,520,000
Per Share at time of gifts (÷ 112790)		24.08
Discount for Minority Interest - 42%(23)		10.11
		$ 13.97
Discount for Class B Stock infirmities per MacMullan - 16 2/3%		2.33
		$ 11.64

(22) Ibid. p. 21

(23) MacMullan's Ex. Q (A 120, 121) corrected for mathematical computation errors and the elimination of Aniline's acquisition of Rubberoid where "minority and majority" interests were acquired as a unified transaction in May 1967, and eliminating transactions when the acquisition of the minority interest resulted in 100% ownership. See Tr. 201.

Smith's table of discounts for acquisition in 1968 by the Value Line Development Capital Corporation reflects an average discount of 44% for minority interests in unregistered shares of publicly held companies. (A 66, 74)

If Smith's procedure is adopted of using a 60% discount for minority interest, unregistered shares and non-voting, non-information infirmities (A 70), the fair market value would be $9.63 a share ($24.08 x 40%).

These values are approximately the same price at which 4790 shares were sold directly by the corporation to seventeen individuals at the time of the gifts. In fact, in order to induce the individuals to purchase said shares, a disposable market was provided through the means of a buy-back agreement in the event of death or termination of employment. (Ex. 14-N; A 35). These sales were in lots requiring from $900 to $8,000 and averaging $2,818. (Stip. Par. 12; A 18). How could the fair market value for 3 blocks of 8,600 shares each, and 2 blocks of 25,680 shares each, without a disposable market (there was no "put" of a buy-back agreement for these shares) (A 128, 192) be worth any more, if as much?

While the sale of 4,790 shares Class B Stock of Modern Maid were to employees and business related parties, they bore no relationship to the employees' regular compensation or positions occupied, and were not intended as compensation. The individuals were offered the shares and they bought what they desired and could afford (Stip. 12; A 18). The $10 price was based on the book value of Modern Maid stock (unconsolidated) and the fact that no dividends were being paid on the stock (Ex. 7-G; A 30, 126).

These independent arm's length sales are the best criteria of fair market value. Morris Messing, 48 T.C. 502 (1967); Fitts Estate v. Commissioner, 237 F. 2d 720 (8th Cir. 1956); The Elmhurst Cemetery Company of Joliet Memo B.T.A. Docket No. 58813, P.H. Memo B.T.A. ¶ 34555 (1934), aff'd. 57 S. Ct. 324 (1937); Reg. 25.2512-2.

MacMullan's third approach "Comparable Public Enterprise Approach" is only a slight refinement of his "Price-Earnings Ratio Approach". He has added a dash of seasoning to his unpalatable brew of Price-Earnings in an effort to disguise its admitted faults (Ex. Q, A 34, 35), but the seasoning has no relation to the brew as can be seen in the 5 to 1 variation in the net worth as a percent of total market value and the 2-1/2 to 1 variation in sales as a percent of total market value in the comparables used. Only a moment's reflection is needed to recognize that market price of stocks has little correlation to total sales, unless the sales are in close correlation to earnings, and then sales/market value is just a repeat measure of earnings/market value. To be statistically valid sales/market value ratios should closely approximate each other, at least in the same industry. What variation exists should be relatively small, but MacMullan's five "comparables" have deviations from the sales mean of 48% on the downside and almost 36% on the upside.

Deviations from the mean of net worth as a percent of total value are even more severe, almost 60% on the downside and more than 90% on the upside.

The comparative appraisal method adopted by MacMullan even when more thoughtfully and accurately pursued has been subject to criticism by the courts. In Righter v. United States, 439 F. 2d 1204, (Ct. Cl. 1971), the Court in commenting on such statistical approach stated:

> "The Comparative Appraisal method produces, nevertheless, no magic formula which rigidly gives the exact valuation answer. Companies are rarely identical in size, operation, or product and allowances must be made as the statute says, for 'all other factors'. This would necessarily include the very fact of unmarketability of the stock of a closely held corporation. In the last analysis much necessarily depends on the informed judgment of the knowledgeable investor concerning the refinements and adjustments to be made in arriving at the ultimate valuation figure. Thus it is not surprising that in this field the opinions of experts are considered to be peculiarly appropriate. (emphasis supplied)."

In the Righter case, the stock to be valued was a manufacturer of "Scrabble" and "Parchesi", trademarked items. The

government produced two "experts" who used the comparative appraisal method. The first expert selected four public companies in the game and toy business and determined ratios between their market prices and their earnings and book values. On the basis of earnings for the most recent five calendar years, their price/earnings ratio was 41; on the basis of the last year's earnings, the price/earnings ratio was 29.55. Applying those ratios to the stock to be valued resulted in values of $3,649 and $3,644 a share, respectively.

The ratio of market price to book value of the four "comparables" averaged 5.76 to 1 and applying that ratio to the book value of Selchow & Righter Co. (the stock being valued), $900 a share, the value would be $5,183 a share. Since these values were too high, the "expert" then concluded the subject stock if publicly traded would be within the range of $1,800-$2,000 a share.

Since S & R stock was not publicly traded and was a minority interest of about 17%, and had only two products, indicating a lack of new product development, and was subject to competition from larger companies, a discount of 45% to 50% was allowed and a value of $1,000 arrived at, as the Commissioner had determined.

The Government's second expert selected three "comparables"

(included in the first expert's four) and after many statistical fol-de-rols, he arrived at values between $2,200 and $2,500 a share. He gave consideration to other facts relating to S & R operations: Sales in last five years had increased by 78%; earnings per share had risen by 280%; average dividend payout was approximately 50% of earnings which would reasonably continue. He noted the strong liquid position of balance sheet, lack of substantial indebtedness, and signs of good management. However, due to the non-public character of S & R stock and the minority interest factor, he felt the fair market value was $950 a share or within the range of $900 - $1,000 a share, a discount of approximately 60%. Quite a difference from the 8%, 25% plus $5.00 used by MacMullan (when costs were higher), an effective discount of about 40%.(24)

The Court in Righter rejected the "comparables" as being similar and stated: "Therefore, since the basis for the opinions of the defendant's expert witnesses was grounded on the comparison of companies that were not truly comparable, their analysis based on the comparative appraisal method have but little, if any, weight in establishing the fair market value of S & R stock."

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(24)

Total value	$ 7,000,000
Preferred stock (92% of $2,520,000)	2,318,000
	$ 4,682,000
Common stock valued at 112,790 x 25	2,819,750
Discount	$ 1,862,250
Percent Discount 1,862,250/4,682,000	39.77%

However, since the plaintiff had attempted to sustain its contention only by relying on the sale of the stock at issue, which sale the Court held was tainted, and did not submit any expert testimony, the Court was impelled to set its own value at $700 a share, approximately 22.22% below the book value at the close of the preceding year and less than 20% of the comparative average price/earnings ratio of government expert #1 ($3,646), 14% of his price/book value ratio ($5,183), 36% of the comparative lowest price/earnings ratio ($1,931) and 27% of the comparative lowest price/book ratio ($2,555).

The factual basis for the Court's opinion in Righter v. U.S., supra, and the whole rationale of that case is equally applicable to the case at bar. More so, since the Petitioners-Appellants here did present credible expert opinion testimony on market values.

Petitioners-Appellants' gifts were made up of two blocks of 25,680 shares and three blocks of 8,600 shares. The stock was non-voting, had no voice in management or business policy, was not paying a dividend nor were dividends in the offing, and each block was a minority interest.

What could a purchaser do with such shares which would require a sizeable investment even at the price of $5 a share. If only one buyer could be found, a total investment in excess of $385,000 would be required. If three or more buyers could be found for such shares, a minimum of $128,000 would be required

from a buyer of one of the blocks of 25,680 shares.

Where could such buyers be found? The shopkeeper, the dentist, the pensioner, who might be inclined to purchase food stocks most likely wouldn't have the required funds. Large pension and endowment funds, and insurance companies were not buying non-voting, non-dividend paying stocks in closely held corporations. Venture capital funds would not be attracted by the type of business of Modern Maid. It wasn't the kind of growth or glamour industry that venture capital funds were seeking in 1968. (A 284, 285).

Such a purchaser without a voice in the company for the present (1968) or forseeable future, could not demand employment, dividends, merger, sale to the public, or liquidation. By the very terms of the charter, this condition could prevail through the buyer's lifetime and beyond.

What prospects for common stock dividends were there? Jack Silverman who controlled the company, was receiving a substantial salary, which he could increase at will, and dividends on preferred stock of almost $72,000 a year. (14,389 shares x $5 a share). He certainly had no incentive to pay common stock dividends. Furthermore, conservative management provided for internal financing instead of the use of borrowed funds. (A 323)

Jack Silverman, about 60 years old, was not looking toward retirement. Concervative in attitude, with growing sales, but flat earnings during 1965, 1966 and 1967, he was not entertaining

any thoughts of "going public" or "selling out". He wanted to keep the business for his two sons, one of whom was already in the business.

The sons, learning the business and in all likelihood the eventual recipients of the voting stock, could very well continue the business as a family business.

There would be no market in which a purchaser of the Class B common stock could really dispose of his shares, particularly since he wouldn't even have and was not entitled to annual reports of company operations. His only hope for a market would be the company itself or management if they were so inclined and had the funds to make the purchase.

Under such circumstances, both Harold Wit and Herbert Cannon, people with actual expertise in this area by training and long experience, with justifiably established reputations, testified buyers might be found, or at least they would counsel buyers, to make a purchase at $5 to $6.75 a share if public sale or merger with a public company could be anticipated in about 3 to 5 years or only $2 a share if public sale or merger was indefinite.(25) (A 148, 179, 180).

Petitioners-Appellants submit that in August and September 1968, no consideration was being given, or even contemplated, to a public sale or merger with a public company. To construct a value based on 1968 market prices and then discount

(25) The expert opinion of what a knowledgable investor would pay preferred by the Court in Righter v. Commissioner, supra, and followed by the Court in Whitemore v. Fitzpatrick, 127 F. Supp. 710 (Conn. 1954)

for the cost of going public and minority and non-voting interests, while a statistical measure, has no basis in realty. For though such a statistical measure may be a means of valuing a business as a whole, it is not appropriate for the Class B common stock subject to gift. It is an "if-value", but not actual market value at the time.

In Whitemore v. Fitzpatrick, supra, the Court had the problem of valuing for gift tax purposes three blocks of 200 shares each out of total capital of 820 shares of J. H. Whitemore Company, a personal holding corporation.

The stock was valued in the gift tax return at $1,000 a share, but increased by the Commissioner to $3,228 per share.

Judge Hincks found that the value per share based on the market value of Whitemore Company's assets was $3,118, but then determined fair market value of the shares subject to the gift to be $1,559 if valued as majority control or $1,057 a share for each 200 share block. It should be noted that the $1,057 was arrived at by taking the appraisal values of petitioner's three witnesses $850, $1,000, $1,200 a share, averaging them, $1,017 a share, and adjusting for an increase in the market value of one of the company's assets, Peter Paul stock, found by the Court.

In Whitemore, the Court agreed with the criteria of plaintiff's experts-power of control, liquidity of the investment, opportunities to revamp asset holdings, net return by way of

dividends as compared with other opportunities in the open market, the tax aspects of the purchase -- all the factors which a level-headed investor contemplating such a "large investment" would make. Large, in that case, was a little over $200,000, based on the court's finding of $1,057 a share.

The Court stated:

> "In view of the lack of market for the stock, there would be extraordinary difficulty in finding a buyer who would invest something over $200,000 in a minority interest in a Naugatuck corporation such as the Whitemore Company without an established dividend record of which about one-quarter in value of assets was in non-liquid form."

The foregoing facts and argument establish that the Court's finding of a value of $25 per share is clearly erroneous.

II

THE COMMISSIONER'S VALUE OF $48 A SHARE FOR THE CLASS B COMMON STOCK OF MODERN MAID WAS ADMITTEDLY ARBITRARY AND ERRONEOUS AND THE COMMISSIONER HAS THE BURDEN OF PROVING THE CORRECT VALUE.

In his statutory Notice of Deficiency, the Commissioner valued the Class B Common Stock of Modern Maid at $48 a share. No basis for such a figure was given. At the time of trial, the Commissioner abandoned this valuation and opted for a value of $25 a share, approximately one-half of the original value.

Appellants contend that where the statutory notice is patently arbitrary and erroneous, the presumption of correctness of Commissioner's determination falls[26], taxpayers need only show error and need not prove the exact amount of the deficiency, if any.

Appellants accepting the Tax Court's open declaration that the Commissioner's presumption of correctness no longer prevails and the Court's expressed rejection of the Commissioner's expert's appraisal report (A 240) relies upon the opinion in Suarez, 61 T.C. 841 (1974).

Since, in that case, the respondent produced no evidence free of taint, the Court held for the petitioners, the petitioners having produced evidence to show error in Commissioner's statutory notice of deficiency.

In the case now before this Court, the Commissioner has acknowledged error of almost 50% in his statutory notice of deficiency, petitioners have submitted a plethora of evidence to establish a prima facie case, the burden has shifted to the Commissioner and his only expert's construction of fair market value was struck down by the Tax Court.

Accordingly, Appellants submit that (even if they failed to establish the value contended for of $5 a share, which would give rise to a refund of tax, there should not be any finding of a deficiency.

(26) Even the Tax Court during the trial of this case conceded the applicability of this principle of law. (A 257).

In Kaufman v. Commissioner, 374 F. 2d 789 (4th Cir. 1966), the Court held that when the determination of the Commissioner is found to be invalid, the determination of the Tax Court "must be based upon substantial evidence and it is incumbent upon the Commissioner, not the taxpayer, to come forward with the evidence." (emphasis supplied)

In Kaufman, the Tax Court determined a 30% error in the Commissioner's valuation set out in his statutory notice of deficiency. In the instant case on appeal, the Commissioner himself has asknowledged error of almost 50% in his statutory notice of deficiency and to support his reduced valuation submitted the testimony and appraisal report of MacMullan. Appellants under Point I have amply demonstrated the total invalidity of the MacMullan appraisal which was recognized by the Tax Court during the cross-examination of MacMullan, when it stated ". . .there are so many factors that are missing that the Court would be inclined to -- to entertain a motion that we strike all of them (appraisals) frankly." (A 240)

In Federal National Bank of Shawnee, Oklahoma v. Commissioner, 180 F. 2d 494 (10th Cir. 1950) the Court stated:

> "The burden of proof was on the taxpayer to show that the Commissioner's determination was invalid, but to meet that burden it was sufficient for the taxpayer to show that the determination was excessive and invalid. The taxpayer was not required to prove that he owed no tax or the correct amount of tax he did owe. It may not be held that he is bound

to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount of tax, if any, that might be lawfully exacted." (emphasis added)

See also A & A Tool & Supply Co., et al. v. Commissioner, 182 F. 2d 300 (10th Cir. 1950).

In Helvering v. Taylor, 70 F. 2d 619 (2nd Cir. 1934), aff'd. 293 U.S. 507 (1935), the Court stated:

"If the burden of proof goes so far as to demand not only that the taxpayer show that the deficiency assessed against him is wrong, but what is the proper deficiency, or that there should be none at all, the decision (B.T.A.) was right even though we know the tax is too high. In an action to recover taxes unlawfully collected the burden does go so far. (citations) But the reason for this is obvious; a plaintiff, seeking an affirmative judgment measured in dollars, must prove how much is due. His claim is for money paid and he must show that every dollar he recovers is unjustly withheld. So it is not enough merely to provide that the tax as a whole was unlawful; some of the dollars he paid may nevertheless have been due. But this reasoning does not apply when the proceeding is to review an assessment. Although that does indeed partake of the nature of a judgment, and the taxpayer has the burden of proving that it was wrong, after he has done so, he need not, at least under ordinary principles of procedure, prove that he owed no tax, or what was the tax that he did owe. The original assessment rested upon a finding, presumptively correct, but the presumption of its correctness does not extend to other findings which the Commissioner has never made. Any other result would invert the ordinary rules of procedure by imposing a burden of establishing

> a negative upon the obligor; indeed of disproving the existence of all possible obligations. (emphasis supplied)

With the recognized invalidity of MacMullan's testimony and report, Petitioners-Appellants contend the Commissioner's determination should be rejected.

Despite the burden of proof now being on the Commissioner, the Tax Court held the petitioners' proof that "going public" was not foreseen at the time of gift "does not negate the respondent's claim that petitioners' future plans went beyond the first step, with which we are here concerned."(27)

The Court also stated "Although Ladenburg, Thalmann & Co. was unquestionably the best qualified 'expert' to express an opinion with respect to value of the stock of Modern Maid, petitioners chose not to present the testimony of the firm." (28)

Petitioners-Appellants submit the burden of proof being upon the Commissioner, once he acknowledged error in his original determination, it was not incumbent upon them to disprove a mere "claim" of the respondent with respect to petitioners appellants' future plans, or to call Ladenburg, Thalmann & Co.(29) even assuming they were the best qualified

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(27) (A 331, fn. 4)
(28) (A 334)
(29) Respondent's efforts to contact a knowledgeable party from Ladenburg, Thalmann Co. were fruitless since such party was no longer available, being somewhere in Texas.

experts to value the kind of stock given as a gift in 1968.

With respect to future plans of "going public", the record does contain the following.

Q. "Up to and including the time of the gifts, did you have any intention for Modern Maid Food Products, Inc. to become a publicly owned corporation or to merge or sell said corporation?" (emphasis added)

A. (Jack Silverman)"No, there was not."

There is no basis in the record nor has respondent or the Court even intimated any challenge to the credibility of Jack Silverman. In fact the only evidence in the record on this point (exhibits and testimony) shows that going public was a happenstance arising out of events occurring after the gifts were made.(31) The respondent submitted no proof that the petitioners at the time of the gifts contemplated going public at some future unspecified date.

Petitioners-Appellants submit the Court below erred in failing to recognize that the burden of proof was on the Commissioner and that the evidence he adduced was toally inadequate to sustain any deficiency.

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(30) (A 129)
(31) (A 40-42, 129, 131, 137, 141, 142, 331 fn. 4)

III

THE TAX COURT ERRED AS A MATTER OF LAW IN THE CRITERIA USED IN DETERMINING VALUE AND DEPRIVED PETITIONERS-APPELLANTS OF DUE PROCESS OF LAW.

Appellants respectfully submit the Tax Court erred as a matter of law in the following respects:

1. The Court adopted a method of valuation completely alien to any proposed by the respondent or petitioners. Such action deprived petitioners-appellants of the right to cross-examine, offer rebuttal evidence, or show in their brief the error in the Court's method. In accordance with Tax Court rules, the petitioners and respondent exchanged their respective expert's appraisal reports prior to the trial and petitioners prepared their case to show the invalidity of respondent's expert's appraisal in concept, data selection and mathematical computations. Certainly, the petitioners' due process rights were impaired when they were deprived of the right to refute a basis never advanced by the respondent, but used by the Court for its opinion.(32)

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(32) That the method and data used was the Court's own making is, in part, noted in the transcript (A 256, 257). "I think I would like to be brutally frank at this point, and that is that the problem that Mr. Gelfand brings out with respect to the comparisons in this witness' report (MacMullan's), I find the same problem exists with respect to the American Appraisal report, so where does that leave us? That leaves us with two witnesses

It should be obvious from Judge Quealy's comments that the determination of the Court was not based upon the testimony and appraisal reports before it, but upon some undisclosed knowledge within the Court's own mind.

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(32) cont'd.

who said they wouldn't have paid more than $6 or $2 a share. But I'm not sure that is sufficient proof of anything. They weren't the only buyers at this time, and they certainly didn't have any examples to where they had bought any stock, on that kind of a pricing, and maybe that's all they would have paid, but there wouldn't have been any sellers at that price. So, I think that we are left with the -- I think that counsel for the Respondent said that he no longer is holding out for the $48 in the notice of deficiency, so we don't even have the presumption to fall back on.

I think the Court will just have to take out my old slide-rule, what I used as a re-negotiator --

Mr. Musoff: If, Your Honor please, we still have Mr. Cannon in the courtroom, and in rebuttal, we can put him on, and he can detail transactions that he was actually involved in during the year 1969.

The Court: I know, but counsel we are going to run into precisely the same problem, in that you are going to be comparing apples and oranges, and -- so that for every example that Mr. Cannon can give, I can probably give you an example of the peripheral computer field at that time when the prices were absolutely incredible.

Mr. Gelfand: But crumbs --

The Court: He wasn't -- I'm sure Mr. Cannon in 1969 wasn't interested in buying into the flour business at any price.

The Court: Or 1968." (emphasis supplied)

Appraisal reports and testimony had been submitted by both respondent's and petitioners' experts using the price-earnings method of valuation based on alleged comparable companies. Both experts applied the price-earnings ratio to total corporate earnings from which were subtracted:

a) The estimated cost of a public offering;

b) The value of the preferred stock;

c) Discount(s) for minority interest and Class B stock infirmities.

The petitioners definitively demonstrated the inapplicability of the appraisal of respondent's expert[33] and the Tax Court was of similar opinion at the time of trial.[34] The Tax Court in its findings of fact stated:

> "A multiple of ten times average earnings was a reasonable basis for valuation of the Class A Common Stock of Modern Maid."

No basis for this finding was given or exists in the record. Petitoners-Appellants' expert, did use that multiple of earnings, but that was a multiple of total corporate earnings based on an assumed public offering and from which deductions were taken for the cost of going public, the value of the preferred stock and the discount applicable to minority interest and Class B stock infirmities. The Tax Court has used the same ten times earnings

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(33) Ibid pp. 17-34

(34) (A 240)

multiple, but applied it to the pro-forma earnings per share of Modern Maid as if Modern Maid were already a public company, which it wasn't, and without making the deductions used by both respondent's and peittioners' experts. If these deductions were made, a quite different valuation would result.(35)

Appellate Courts have held that the Tax Court having rejected all the evidence of all the witnesses, thus leaving no evidence supporting them, may not sustain the Commissioner's determination of fair value (rent & salaries), J. H. Robinson Truck Lines, Inc., 183 F. 2d 739 (5th Cir. 1950) and cases cited therein.

In the instant case, the Tax Court has pointedly rejected the testimony of all experts leaving as evidence the testimony of Jack Silverman on the determination of value and the actual fact that 4,790 shares of Class B common stock of Modern Maid was sold to seventeen individuals at $100 a share in the month of the gifts. The Tax Court may not ignore this evidence and determine value "upon its own innate conception" of values. Loesch & Green Const. Co. v. Commissioner, 211 F. 2d 210 (6th Cir. 1954)

2. The Tax Court in its opinion stated:

> "The Court is not called upon to consider the tax consequences of the re-classification of the Class B non-voting shares and the public offering of such shares. Until such event took place, all that the donees received was a non-voting interest in a family-controlled corporation."(36)

(35) Ibid. p. 32
(36) (A 330)

But then the Court proceeded to do what it stated it was not to do. In valuing the shares, it referred to the future public offering which even the Court below recognized was brought about by a transaction occurring after the time of the gifts and not foreseen at the time of the gifts.(37)

The Court's advent into the realm of speculation about the donor's contemplation in August and September 1968 to "go public" at some future unspecified date, concerning which there isn't a scintella of supportive evidence was specifically banned by the Supreme Court in Olsen v. United States, 292 U.S. 246 (1934) when it stated (p. 257):

> "Elements affecting value that depend upon events or combinations of occurrences which, while within the realms of possibility, are not clearly shown to be reasonably probable should be excluded from consideration, for that would be to allow mere speculation and conjecture to become a guide for the ascertainment of value -- a thing to be condemned in business transactions as well as in judicial ascertainment of truth." (emphasis added)

During the trial the Tax Court expressed the opinion (A 245):

> "I think frankly if somebody had started with the price at which it went public and worked back from there, it probably would have been a little more scientific than any approach I have heard so far, because you have a point of reference to -- to go from."

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(37) This proof was substantial and conclusive and is set forth in the trial record (A 40-42, 129, 131, 137, 141, 142, 331 fn. 4.)

This approach was categorically and colorfully refuted in Morris Messing, supra, where Judge Tannewald stated:

> "A publicly traded stock and a privately traded stock are not as respondent would have us assume, the same animal distinguished by size, frequency or color of its spots. The essential nature of the beast is different.
>
> * * * * *
>
> It is a matter of common knowledge that, as a result of the vagaries of the stock market and other national and international events, many a contemplated public offering never sees the light of day, and that because of factors effecting the market at the particular moment of the public offering, the offering price can be radically different from the one originally contemplated. In September 1961, there was no probably basis for predicting a public offering would, in fact, take place and even less for estimating the particular price of the offering."

In Bruce Berckmans, T.C.M. 1961-100 stock was purchased on April 15th at $1.00 a share by the taxpayer and the underwriter after letters of intent had been signed for a registration and public sale of stock, checks in payment for the stock were deposited by the Company on April 29th and a registration statement was filed on May 12th and became effective on May 31st. The public offering was at $9.50 a share. The Tax Court held the value of the stock at the date of purchase was its cost, $1 a share, since all of the events leading up to the offer of $9.50 was only contingent on April 15th though contemplated on that date.

Who in 1968 would pay anything like the Tax Court found of $25 a share or even $10 a share, more than $1,900,000 or $770,000, respectively, on the chance some events would occur as did occur. Suppose the need for additional funds didn't arise until 1974. What would the picture be? Common voting stock of Modern Maid now a marketable security sold at less than one-third of book value. Those beautiful three-year average earnings of $616,000 a year became losses of $235,000 in the fourth quarter of 1973 and $263,000 in the first quarter of 1974.(A 310) Where would such an investor now be? Is it any wonder Cannon and Wit, experts in their field, testified the way they did?

3. The Tax Court erred in its rejection of the truly expert testimony of Herbert Cannon and Harold Wit with notable credits of active experience and success in advising about and marketing of securities in the financial community. The testimony of those experts was not diminished upon cross examination or negated by contradictory evidence with respect to their special expertise. Their testimony and appraisal reports (A 44-49, 76-83) were rejected not because they weren't valid, but only because the Court was of the opinion that the donors would have marketed their stock in a different fashion or there

wouldn't be any sale at all.[38]

This rejection by the Tax Court of unimpeached uncontradicted testimony which was not diminished upon cross-examination has been specifically repudiated by other courts. Chesapeake & Ohio Railway Co. v. Martin, 283 U.S. 209, 216-217 (1931); Pennsylvania Railroad Co. v. Chamberlain, 288 U.S. 333, 340-341 (1933); A&A Tool & Supply Co. v. Commissioner, supra; Foran v. Commissioner, 165 F. 2d 705 (5th Cir. 1948); Loesch & Green Const. Co. v. Commissioner, supra; Wooster Rubber Co. v. Commissioner, 183 F. 2d 739 (5th Cir. 1950); Wright-Bernet, Inc. v. Commissioner, 172 F. 2d 343 (6th Cir. 1949); Baltimore Dairy Lunch, Inc. v. United States, 231 F. 2d 870, 875 (8th Cir. 1956); Tank v. Commissioner, 270 F. 2d 477 (6th Cir. 1959; Blackmer v. Commissioner, 70 F. 2d 255 (2nd Cir. 1934); Herbert V. Riddell,103 F. Supp. 369, 389 (S.D. Cal. 1952). In fact, the Tax Court itself has cited with approval and followed Herbert V. Riddell, supra and Wooster Rubber Co. v. Commissioner, supra; in Robbins Tire & Rubber Co., 53 T.C. 275 (1969)

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(38) "The expert testimony presented by the petitioners failed to take into account the fact that if petitioners intended to sell a substantial interest in Modern Maid -- and the Class B stock represented approximately two-thirds of the equity after the preferred stock -- they would have adopted a different course of action or there never would have been a sale." (A 334)

To adopt a "different course of action" (not spelled out by the Court), but presumably a public offering, would:

(a) Have been illegal at that time without a registration with the Securities and Exchange Commission. Modern Maid had already entered into an agreement to sell shares to seventeen persons and offerings of Class B stock to a number of purchasers could have subjected the offerors to criminal and civil sanctions.

Section 77e of Title 15 of the United States Code prohibited the offering (let alone sale) of securities in interstate commerce unless a registration statement was filed with the Securities & Exchange Commission. The exemptions provided by Section 77d in the case of private offerings was not applicable to the Class B stock of Modern Maid which was so proscribed that a holder was not entitled to obtain financial data, annual reports, or attend stockholder meetings. See Securities & Exchange Commission Release No. 4552 dated November 6, 1962 which later was formally enunciated as Rule 146, and Release No.5487 interpreting Rule 146.

Release No. 4552 in setting out the policy of the Securities & Exchange Commission relative to exemptions for private offerings cites the Supreme Court in S.E.C. v. Ralston Purina Co., 346 U.S. 119 (1953) to the effect that "the exemption

does not become available simply because offerees are voluntarily furnished information of the issues. Such a construction would give the issuer the choice of registering or making its own voluntary disclosures without regards to the standards and sanctions of the Act." (A 374)

b) Convert the property which was the actual subject of the gift into some entirely different property. To use publicly owned voting stock as the basis for valuation would be not only a "beast with a different nature", but an entirely different beast. It would represent loss of control by the donors of their company. This is something they were unwilling to do in any event -- even with respect to gifts to their own children.

Is there any question that non-voting stock in a closely held company on which no dividends are being paid is entirely different from stock in a publicly held company? In the first, one is completely locked in -- there is no possible liquidity, no market. In the second, one may withdraw at one's option.

The Tax Court's reference to the unwillingness of a donor to sell at the price a willing buyer would pay was raised by the government in Whitemore v. Fitzpatrick, supra, but rejected by that Court. In that case the Court found the

fair market value of the underlying assets was $3118 per share. Taxpayer's experts' testimony of obtainable market price ranged from $850 to $1200 per share for minority interests (a total of 73% had been given to three sons). The government argued the plaintiff, as the sole owner, would not be a willing seller at the only price which a buyer according to plaintiff's experts would buy. The Court (Judge Hincks) stated: "Surely this argument is irrelevant to the problem."

The Court stressed the "extraordinary difficulty in finding a buyer who would invest something over $200,000 (200 shares at $1,000 a share) in a minority interest" in a company without an established dividend paying record. The Court presumptively rejected the theory that a larger sum could be realized if a different method of marketing had been pursued by first converting the property into something else.

Imagine what difficulty would then exist to find two buyers who would pay more than $640,000 each (25,680 shares x $25) to buy minority interests of non-voting stock without a market in a company making prepared batter mixes and crumbs for breading! Jack Silverman's gifts were to 2 donees and Seymour Silverman's gifts were to 3 donees, not hundreds or thousands

of donees, and the gifts should be valued accordingly.(39)

It is important to note that Section 25.2512-1 of Commissioner's own regulations defines fair market value as "that price at which property would change hands between a willing buyer and willing seller" -- just one buyer,not many buyers,for such gift of stock in a closely held corporation.(40)

Appellants recognize that the values in any particular case are factual and specific to a particular case, but the criteria used by the Court below in its opinion has no precedent in any guidelines heretofore set out by other courts upon which guidelines appellants and their counsel have a right to rely. Olsen v. United States, supra; Righter v. United States, supra; Whitemore v. Fitzpatrick, supra; Bruce Berckmans, supra; Morris Messing, supra; Estate of Gregg Maxcy, T.C. Memo 1969-158; Richard Makeoff, T.C. Memo 1967-13.

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(39) The Court itself expressed the opinion that Modern Maid Food Products, Inc. stock "wasn't the type of business that would attract so-called venture capital anyway;" (A 284) and that parties with venture capital are not attracted to the type of business of Modern Maid Food Products, Inc. (Tr. 285). In both of these opinions the Court's opinion was confirmed by Herbert Cannon, an expert in raising venture capital.(A 284, 285)

(40) Just as gifts of closely held stock may not be aggregated for valuation, Whitemore v. Fitzpatrick, supra, William Rushton et al., 60 T.C. 272 (1973) reviewed by the Court and affirmed 498 F. 2d 88 (5th Cir. 1974), they may not be broken up for valuation, particularly when such breakup would be a violation of the Securities & Exchange Act or a conversion into different property.

In Morris Messing, supra, the Court emphatically rejected any reference or reliance on the public offering price and relied upon the price of actual sale of stock on June 15 to an underwriter. The gifts were made on September 13th and 16th and a registration statement filed with the S.E.C. on September 27, within two weeks of the gift.

If the Court's determination and opinion in that case is the principle of law to be followed[41] where a registration statement is filed during the month of the gift, how remote and speculative are the possibilities where a public issue is never even contemplated at the time of the gifts, events occur that lead to negotiations beginning seven months later, and the public offering is fourteen months later?

In the Estate of Gregg Maxcy, supra the Court stated:

> "In the instant case we are attempting to determine a price a willing seller of Maxcy Securities shares could get from a willing buyer, not what a buyer may eventually realize." (emphasis supplied)

In Richard Makeoff, supra, 99% of a total common stock capitalization represented by non-voting stock was contributed to a charitable organization. The Commissioner contended such stock since it was non-voting had no fair market value. The Tax Court determined a value of approximately 60% of the total

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(41) Acquiesced in by Commissioner C.B. 1968-1, p. 2.

capitalization -- in effect a discount of almost 40% from book value solely due to its being non-voting stock even though dividends were being paid.

In the light of the actual record, the appellants pose the question once again, assuming the financial means

> * * * "How much would I invest to acquire 25,680 shares of Class B non-voting, non-dividend paying stock of Modern Maid Food Products, Inc. in August 1968 knowing the earning history and book value up to December 31, 1967, knowing those controlling the business had no plan or intention of going public, knowing that the substantial salaries and preferred dividends vitiated any incentive to declare dividends on the common stock, and knowing that the management intended to leave control to their children?"

The Tax Court apparently overlooked Jack Silverman's testimony and the exhibits in the case[(42)] when it stated "nothing in this record would support the hypothesis that 'those controlling the business had no plan or intention of going public' ".

The Court below has taken the statement "knowing that the substantial salaries and preferred dividends vitiated any incentive to declare dividends on the common stock" to imply acting in violation of a quasi-fiduciary relationship and proceeds to destroy such a strawman.

The fact is that the receipt of substantial salaries

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(42) Ibid p. 47

and preferred dividends does weaken the incentive to declare common stock dividends. Such failure to declare dividends need not be violative of a quasi-fiduciary relationship. It may be justified as a conservative business policy and the desire to finance growth internally as testified to by Jack Silverman.

Any knowledgeable buyer of such Class B stock would be aware of such condition which would obviously affect the price he would be willing to pay. Who wants to buy into a company for the purpose of charging and proving violations of a quasi-fiduciary relationship? As a matter of fact, the record shows no dividends have been declared on the common stock of Modern Maid after December 31, 1967 even though the preferred stock was eliminated in the 1969 recapitalization.

The foregoing clearly indicates that the Tax Court erred as a matter of law in the criteria used in determining value and deprived appellants of due process of law.

In re: Seymour Silverman, et al.,

Appellants,

v.

Docket No.
75-4162

Commissioner of Internal Revenue,

Appellee.

I hereby affirm that service of three copies of Appellants Brief and the Appendix was made this date by mail to Appellees counsel, Hon. Scott P. Crampton, Assistant Attorney General, Tax Division, U.S. Dept of Justice, Wash., D.C. (Attn. Frank Gould, Esq.)

Wallace Immoff
Attorney for Appellants
October 28, 1975

CONCLUSION

The decision of the Tax Court should be reversed and the case be remanded to the Tax Court for entry of decisions of no deficiency and the determination of overassessments based on a fair market value of $5 a share for the Class B Common Stock of Modern Maid Food Products, Inc. subject to gifts on August 21, 1968 and September 24, 1968.

Respectfully submitted,

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October 28, 1975

Wallace Musoff

Of Counsel